

PUBLIC UTILITIES COMMISSION

505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298



September 18, 2003

Alternate to Agenda ID# 2368
Ratesetting

TO: PARTIES OF RECORD IN APPLICATION 02-11-057

Enclosed is Alternate Draft Decision of Commissioner Lynch to the Draft Decision of Administrative Law Judge (ALJ) Bushey previously mailed to you on June 10, 2003.

When the Commission acts on this agenda item, it may adopt all or part of it as written, amend or modify it, or set aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties to the proceeding may file comments on the alternate draft decision as provided in Article 19 of the Commission's "Rules of Practice and Procedure." These rules are accessible on the Commission's website at <http://www.cpuc.ca.gov>. Comments are due on September 26, 2003, and there will be no reply comments. Comments with a certificate of service shall be filed with the Commission's Docket Office and copies shall be served on all parties on the same day of filing. The Commissioners and ALJ shall be served separately by overnight service. Please also provide an electronic copy of the comments to Tom Long at tjl@cpuc.ca.gov.

Angela K. Minkin, Chief
Administrative Law Judge

ANG: epg

Attachment

Decision **ALTERNATE DRAFT DECISION OF COMMISSIONER LYNCH**
(Mailed 9/18/2003)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Point Arena Water Works, Inc. for an order authorizing a rate increase in rates subject to refund producing additional annual revenues of \$70,137 or 56.9% for the test year 2002.

Application 02-11-057
(Filed November 25, 2002)

**INTERIM OPINION REGARDING ACCOUNTING AND
RATEMAKING TREATMENT OF 1995 TAX REFUND**

Summary

This decision grants the City of Point Arena (City) the opportunity to have an evidentiary hearing regarding the accounting and ratemaking treatment of income tax refunds received by Point Arena Water Works (PAWW) over a several-year period ending in 1995, and any associated issues related to the Commission staff audit. The decision directs PAWW to present the estimated additional litigation expenses that would result if there were further litigation regarding the tax refund matter and associated audit issues and permits the City of Point Arena (City) to decide whether it wishes an evidentiary hearing on this issue in light of that information. The decision offers initial guidance regarding the tax refund issue, but this guidance is nonbinding and subject to change in the event that there is further litigation regarding the issue.

Background

In Resolution W-4356, October 24, 2002, the Commission granted PAWW a \$70,137 or 56.9% rate increase, subject to refund. About a year earlier, the Commission had also granted PAWW a \$47,677 or 62.3% rate increase, also subject to refund, based on a finding that such an increase was necessary to provide sufficient funds to meet PAWW's cash operating expenses with no depreciation or rate of return on rate base. The Commission noted that PAWW's last rate case was in 1991, and that PAWW operated at a loss of \$56,687 in 2000. As part of its review leading up to Res. W-4356, the staff conducted two public meetings in Point Arena and prepared an extensive staff report with accompanying audit of the utility's 2000 books of account.

The City objected to the rate increases requested by PAWW and disagreed with staff's review. At the staff's recommendation, the Commission converted this advice letter rate case to a formal proceeding in Resolution W-4356.

Among its other issues, the City differed with PAWW and staff regarding the proper ratemaking treatment of an income tax refund to PAWW from the 1990s. The staff auditor concluded from PAWW's records, that (1) the tax refund had been obtained by PAWW at its own expense, and (2) the money had been used to meet operating and maintenance expenses that utility revenue failed to cover. Accordingly, the auditor recommended the tax refund not be used to lower prospective rates. The City disagreed. In Res. W-4356, the Commission noted that "This difference of opinion can be addressed in the formal proceeding...."

On March 20, 2003, the assigned Administrative Law Judge (ALJ) convened a prehearing conference (PHC). The tax refund was among the matters discussed at the PHC, and the ALJ set a briefing schedule on the

question of “whether or not this issue should be in this proceeding.” The ALJ also set a procedural schedule for the remainder of this proceeding. As noted above, the rate increase proposals at issue here have been through an extensive informal review process with our staff, including an audit and a staff report. PAWW and our staff indicated at the PHC that they would rely extensively on these previously prepared analyses to make the required showing.

The tax refund has great significance for revenue requirement, with the potential of completely offsetting current rate base. Consequently, resolution of this issue is key to the scope of the subsequent portions of this proceeding. The parties have filed extensive opening and reply briefs, with accompanying documentation.

In its initial brief, PAWW provided documents (including copies of cancelled checks) showing that the net state and federal tax refund was \$184,954 and that it had been received by 1995. PAWW also showed that customers did not pay any of the costs of obtaining this refund. PAWW explained that in 1993 AT&T Communications, Inc. (AT&T) agreed to fund a new water main that would enable PAWW to provide fire protection to Point Arena City Hall and High School. AT&T entered into such an agreement to promote good will with the community due to a series of construction failures, with resulting environmental degradation, when crossing streams with its fiber optic cable system. AT&T paid \$660,236.79 to PAWW for the costs of the water main. At the time, AT&T and PAWW believed that federal tax law would characterize such a payment as a contribution in aid of construction, and that the payment would be taxable income to PAWW. Consequently, AT&T and PAWW agreed that AT&T would pay to PAWW the amount of the expected tax in addition to actual construction costs. PAWW then remitted the tax amount to the state and

federal taxing authorities. PAWW subsequently came to believe that changes in the tax laws had resulted in this type of construction payment being no longer considered income. PAWW decided to seek a refund, and AT&T declined to participate in the effort or to share in any amounts recovered. PAWW successfully obtained state and federal refunds.

In its initial brief, the City contended that AT&T's total payment, including the amount for taxes, to PAWW should be included in PAWW's contributions in aid of construction account. For ratemaking purposes, contributions in aid of construction are an offset to ratebase, so the City's proposal would have the effect of reducing ratebase by the amount of refund. The City calculated the total refund to be about \$519,000. The City also argued that the alleged misuse and disappearance of this amount from PAWW's accounts has a significant and continuing impact on the financial capability of the company to provide safe and efficient service.

In its reply brief, PAWW vigorously contested the City's calculation of the amount at issue and referred to the documents attached to its opening brief. PAWW also contended that the City's proposal to use the tax refunds as an offset to rate base would effectively deny PAWW an opportunity to earn a rate of return and would violate the rule against retroactive ratemaking.

The City, in its reply brief, alleged that PAWW had illegally removed the tax refund amount from the contributions in aid of construction account and paid it to the shareholder and affiliated businesses, and that restoring it to the account would correct this error.

Discussion

As previously noted, the tax refund issue has the potential to significantly affect the rates we ultimately approve for PAWW and its customers. The record

contains substantial discussion of this issue already in the form of the staff's audit report, the City's objection to the staff's proposed treatment of the tax refunds, and the aforementioned briefs that have been filed in this docket. We are sensitive to the City's argument that it has not yet had an opportunity to present evidentiary facts that it claims are essential to its position, including its challenges to the findings of the staff audit. Accordingly, our discussion below is intended to provide only initial guidance, not a final determination of the issue. We offer this perspective to provide guidance to the parties, particularly in light of the potential significant impact that the incurrence of additional attorneys' fees could have on the rates paid by PAWW's customers. Below, we outline a procedure for PAWW to estimate the associated expenses and customer impact of further litigation on this issue and for the City to elect whether it wants further litigation regarding this issue in light of this information.

Pursuant to Pub. Util. Code § 451, all rates charged by a public utility must be just and reasonable. The Commission has determined that such rates must be based on the reasonable cost of providing service to customers. Specifically, the Commission uses projections of future costs - a "future test year" - to evaluate whether the revenue to be collected from customers under proposed rates would cover the utility's costs.

For large water utilities, the Commission has set a three-year schedule for each utility to present a general rate case to the Commission. In this way, the Commission can monitor revenue and cost levels to ensure that the utility is neither over nor under earning. (See Re Schedule for Processing Rate Case Applications by Water Utilities, 37 CPUC2d 175 (D.90-08-045).)

For small water utilities, such as PAWW, the cost of presenting a formal rate case to the Commission is a significant expense.¹ The Commission, therefore, has established a simplified procedure for rate case review, which enables small water utilities to obtain rate review and any needed modifications more economically. The Commission has not imposed a specific time schedule on small water utilities to file general rate cases. Despite the flexibility the Commission has allowed small water utilities, the Commission has not wavered from its commitment to small water utilities charging cost-based rates.

Resolution W-4356 describes the staff's investigation and audit that led it to conclude that PAWW had allowed its rates to diverge substantially from its costs, and that it had been losing money since 1994. In 2000, our auditors found that the divergence resulted in operating expenses exceeding operating revenues, which justified an immediate 62% rate increase just to meet cash operating expenses, with no depreciation or return on rate base. Thus, PAWW's 2000 rates bore little relation to PAWW's 2000 costs. Failure to synchronize costs and rates is at odds with our fundamental commitment to cost-based rates.

PAWW sought to correct this imbalance in 2002 with its request to triple its rates. Although the Commission allowed an interim rate increase that more than doubled the rates (subject to refund), customers were understandably distressed by the size of this increase. Such an outcome, however, is directly attributable to PAWW's decisions not to seek rate review for over a decade.

Another likely outcome of postponing rate review for so long was that in the intervening decade PAWW would make management decisions that were

¹ We note that PAWW has reported that expenses for this case to date exceed \$80,000.

inconsistent with Commission policy. PAWW's use of income tax refunds for operating and maintenance expenses was such a decision. When a public utility receives substantial and unexpected revenue, the Commission's strong preference is to evaluate prospectively options for allocating the revenue. Here, however, PAWW's long absence from Commission review has precluded prospective allocation.

The City has presented us with a sound argument for one possible allocation methodology, namely, treating the tax refund as a contribution in aid of construction. The California Constitution and the Public Utilities Code grant us sufficient ratemaking authority over PAWW to allow us to implement this option, and others, if we were to determine that such an outcome was appropriate in the circumstances.

On the other hand, PAWW's shareholders have incurred substantial out-of-pocket losses in the last several years. Our auditor documented a net operating loss of \$56,687 in 2000, and the recently filed 2002 annual report showed a \$28,636 loss, despite the rate increase authorized in October 2002. Losses of nearly \$90,000 in just two years would suggest that over the last several years PAWW's losses have exceeded the net tax refund. We recognize, however, that the City contests these findings of the staff audit and the figures in PAWW's annual report and seeks an evidentiary hearing to present alternative facts.

More importantly, we are compelled to note the practical difficulties inherent in allocating funds that are no longer available. While the Commission can and does impute improperly used funds regardless of the actual availability of the funds, such ratemaking fictions are of little use to a small system, such as PAWW's, which requires actual cash to meet expenses. Accordingly, persuasive facts would be needed to justify setting aside these practical issues.

PAWW management, with the assistance of counsel, sought and obtained the refund on its own initiative and did not seek reimbursement in rates for its legal costs. Moreover, our auditor found that PAWW used the tax refund for operating and maintenance expenses, which kept customer rates lower than a revenue requirement analysis would have supported. In Res. W-4356, we granted an interim increase that more than doubled rates, based on our determination that customer revenue had not been adequate to meet costs.

The City's proposed treatment of the tax refund as a contribution in aid of construction is but one of many allocation methodologies that we might use to address this issue. In its briefs, the City cites extensively to the Uniform System of Accounts (USOA) for the proposition that the tax refund should be returned to the contributions in aid of construction account and used as a deduction to rate base. Simply crediting the amount to that account, however, does not resolve the ratemaking question. It is a well-settled proposition that accounting rules do not control ratemaking. (See, e.g., Decision No. 42068, (September 21, 1948) 48 CPUC 253, 257.) On the other hand, we are free to look to the USOA for guidance.

The Commission has previously changed accounting and ratemaking treatment after the fact, rejecting assertions that to do so would violate the rule against retroactive ratemaking. In Re California Water Service Company, (1994) 56 CPUC2d 4 (D.94-09-032), the Commission ordered Cal Water to change its accounting and ratemaking for sale proceeds from 26 real estate parcels from giving all proceeds to shareholders to dividing the proceeds 50/50 between

shareholders and ratepayers.² The Commission found that: “[Its] ratemaking authority is not constrained by the Uniform System of Accounts” and that such changes to a utility’s accounting and ratemaking treatment do not constitute retroactive ratemaking. (*Id.* at 18.) Here, as in the *Cal Water* decision, the Commission has the discretion to order changes in the accounting and ratemaking for this capital account. The Commission reached its decision in *Cal Water* by “weighing the equities and consideration of the ongoing needs of the utility.” Regardless of how we ultimately decide this issue, we direct PAWW, as we did in *Cal Water*, to comply fully in the future with the Uniform System of Accounts and to seek staff guidance when needed.

If the Commission had been presented with this issue in a timely manner, the Commission would have used its broad discretion in an orderly manner to allocate this extraordinary revenue pursuant to a wide range of potential allocation methodologies. However, retrospective allocation of the funds after the passage of many years adds substantial complexities including the potential for significant accounting adjustments to PAWW’s books. We recognize that these complexities exist, in part, because of PAWW’s failure to file a rate case application for many years. While such accounting adjustments are within the Commission’s authority, such extraordinary actions must be taken in response to compelling circumstances. The burden of proving such circumstances will be on the parties challenging PAWW in this case.

² The Commission concluded that the changes in accounting and ratemaking would not be retroactive ratemaking because the changes would not result in any adjustment to previously collected rates.

In sum, we are displeased with the circumstances surrounding the tax refunds and this long overdue rate case. Based on the argument and offers of proof presented by the City thus far, we are not yet persuaded, however, that these circumstances have resulted in or will result in unjust or unreasonable rates. Therefore, further evidence would need to be provided in order to change the ratemaking and accounting treatment of the income tax refunds.

To ensure that similar issues do not arise in the future, we will order PAWW to file an informal general rate case no less frequently than once every three calendar years.

Procedure for Determining Whether There Will Be Further Litigation on this Issue

We will offer the City the opportunity it seeks to present the evidentiary facts that it believes will cause the Commission to reach a different conclusion on the tax refund issue. At the same time, we are concerned with the level of litigation expenses that have already been incurred in this rate case and the additional litigation expenses that lie ahead. With only 179 metered customers, even modest attorneys' fees could add significantly to customer bills. We believe the City and the ratepayers it represents should be as well informed as possible of the potential impact on rates of further litigation on this issue. Accordingly, within 14 days after the issuance (i.e., mailing) of this decision, PAWW shall file and serve a document that estimates the litigation expenses that it expects to incur if there are evidentiary hearings related to the tax refund issue and any associated issues related to the staff audit. The costs should include the costs of filing briefs on the issue as well as the costs of filing comments on a proposed decision on the issue. The estimate should be broken down by attorneys' fees and other costs and should separately indicate the estimates used for testimony

preparation, evidentiary hearings, briefs and comments on the proposed decision. Within 14 days after the filing of that document, the City may file a response in the event it wishes to take issue with any component of the estimate or otherwise comment upon it.

Based on this information regarding litigation expenses and in light of the tentative conclusion of today's decision, we will then permit the City to make an election as to whether it wishes the upcoming evidentiary hearings in this case to include the issue of the tax refunds, or whether the City no longer wishes to litigate the issue. The assigned administrative law judge, in consultation with the Assigned Commissioner, shall determine the procedure for the City to indicate its decision. If the City elects not to seek a hearing, the City will of course waive any arguments it may have based on the failure to hold an evidentiary hearing. On the other hand, if the City chooses to litigate the issue further, the City risks adding a not insubstantial increment to its citizens' water bills to pay for the additional litigation costs.³

Comments on Draft Decision

The draft decision of the ALJ in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.7 of the Rules of Practice and Procedure. The City filed comments on June 26, 2003, and PAWW filed reply comments.

The City argued that it is entitled to an evidentiary hearing in order to challenge disputed material facts upon which it claims the draft decision relied.

³ In accordance with Resolution W-4356, we anticipate that PAWW will seek recovery of its other litigation expenses related to this rate case, even if there is no further litigation on the tax refund issue.

Without necessarily agreeing with the City's claim that it is legally entitled to an evidentiary hearing, we have modified the proposed decision to permit the City to request an evidentiary hearing on the tax refund and associated staff audit issues, in accordance with the procedures outlined above.

Assignment of Proceeding

Carl W. Wood is the Assigned Commissioner and Maribeth A. Bushey is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. PAWW's last general rate case was in 1991.
2. PAWW received extraordinary revenue in the form of income tax refunds over a several-year period ending in 1995.
3. PAWW did not seek Commission direction as to the disposition of the income tax refunds.
4. The staff auditor concluded that the tax refunds had been obtained by PAWW at its own expense, and the money had been used to meet operation and maintenance expenses that utility revenue failed to cover.
5. There has not yet been an evidentiary hearing on the accounting and ratemaking treatment of the tax refunds and the associated findings of the staff audit.
6. The record thus far does not provide sufficient evidence to change PAWW's accounting and ratemaking treatment of the tax refunds.
7. The City seeks an evidentiary hearing in order to contest certain facts that it believes will demonstrate that it is appropriate to change the accounting and ratemaking treatment of the tax refunds.
8. Further litigation on the tax refund issue could add a not insubstantial increment to the bills of PAWW customers.

Conclusions of Law

1. The Commission's ratemaking authority is sufficient to order changes to the accounting and ratemaking treatment of the tax refunds.
2. The City should be given an opportunity to present its factual showing on the tax refund issue and associated findings of the staff audit in an evidentiary hearing.
3. PAWW should be required to detail the additional litigation expenses it expects to incur if there is an evidentiary hearing regarding the tax refund and associated issues.
4. PAWW is entitled to request recovery of its reasonable litigation expenses in this rate case.
5. The Commission retains the discretion to determine which litigation expenses are reasonable and subject to recovery in rates.
6. PAWW should file an informal general rate case no less frequently than once every three calendar years.

INTERIM ORDER

IT IS ORDERED that:

1. PAWW shall file an informal rate case no less frequently than once every three years.
2. Within 14 days of the issuance (mailing) of this decision, PAWW shall file a document, as further described in the text of this order, that estimates the litigation expenses it expects to incur if there is an evidentiary hearing related to the tax refund issue and the associated findings of the staff audit.
3. The assigned administrative law judge, in consultation with the assigned commissioner, will establish a procedure for the City to indicate whether it

wishes an evidentiary hearing on the tax refund issue and the associated findings of the staff audit.

This order is effective today.

Dated _____, at San Francisco, California.